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AUTHOR	Daicoff, Darwin W.
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ABSTRACT

In this article, the author analyzes recent court cases that struck down State school finance systems as being inequitable. Examined are such characteristics of current finance systems as the inequalities of the property tax, the variations in per pupil expenditures, and the variations between poor and rich districts. The report includes a discussion of the effects of using income or sales taxes as alternatives to property taxes for financing education. (JF)

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THE ECONOMIC IMPLICATIONS OF RECENT COURT DECISIONS REGARDING EDUCATIONAL FINANCE

By DR. DARWIN W. DAICOFF

Professor of Economics, The University of Kansas

A number of recent court decisions have enunciated the principle that the quality of public education in a state may not be a function of wealth, other than the wealth of the state as a whole; three or four states have been held in violation of this principle of "fiscal neutrality."[1] The courts found that educational expenditures, associated property taxes, and the resultant quality of education, differ significantly among school districts. Accordingly, pupils attending publicly financed elementary and secondary schools and perhaps taxpayers have been denied the equal protection guaranteed by the 14th Amendment. Because the states in which the courts have spoken have systems for financing education that are fairly typical of the systems used in most of the nation, the court rulings have almost nationwide implications.

While all the constitutional questions involved in these cases have not been conclusively resolved, while all the questions of fact have not been determined and while the U. S. Supreme Court has not yet considered this round of cases attacking the way public elementary and secondary education is provided and financed in the United States, enough has been established to make worthwhile an analysis of the implications of the decisions that have been rendered, and to analyze the consequences of maving to a system of educational finance that is consistent with the principle of fiscal neutrality.

THE CURRENT SYSTEM OF FINANCING EDUCATION

Local School District

In the context of recent court decisions, the essential feature of current public school finance is that within a state there are very significant differences among school districts in their ability to provide for public educational needs in the district. Variations in per pupil expenditures of 2 or 3 to 1 are fairly common within many states; variations in per pupil assessed value are even more unequal. This inequality results from a number of causes. First, school districts have generally been carved out of states as a matter of political convenience; they have not been created so as to secure interdistrict equality in the ability to finance public education. Inequality results because most states have regions of high and low wealth and even more because different sections of metropolitan areas have very large variations in wealth.

The second cause of inequality is a reliance on the property tax. Of course, not all property is taxable nor are all types of property taxed to the same extent. In addition, there is a well known lack of correlation between property values and the ability to provide public services. Consequently, differences in taxable property values per pupil can be greater than differences in wealth as measured by alternatives such as income.

A third feature is also associated with ability of the citizens to pay for education. This feature is concerned with the other public demands made on the citizens of an area, a concern particularly important for the central city residents of a metropolitan area. The necessity of supplying a wider range of services in the urban center than are provided at a much lower level, if at all, in less urban areas and the generally higher cost of providing each service make non-educational public costs much higher in the central city than in the remainder of the area. This phenomenon has been referred to as the "fiscal overburden." The courts have made much of the wealthy district's ability to tax little and spend much. In Serrano v. Priest the court said, "affluent districts can have their cake and eat it too; they can provide a high quality education for their children while paying lower taxes. Poor districts, by contrast, have no cake at all."

A fourth factor results from the fact that educational costs and needs differ among districts. It is often more costly to provide the same level of educational services in a central city than in suburban areas. Equivalently qualified teachers may demand a higher wage to work in the central city than they would require in the suburbs. To bring each pupil to the same level of educational attainment may require still larger expenditures in the urban center. Smaller

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class size and specialized instruction may be required to compensate for the educational disadvantages inherent in the deprived central city child. Finally, still further expenditures would be called for if the aim were to offset the disadvantages, such as those resulting from social-economic disadvantages, of the deprived who tend to be concentrated in the urban centers. It should be noted that while a very substantial difference exists between the central city and the suburbs in terms of their ability to provide for educational needs, very great differences exist among the suburbs themselves; these can be greater than the differences between the central city and the suburbs.

The State's Financial Role

All states assist local school districts in the financing of public education. This aid has two general purposes: to provide for the general support of education and to equalize financial resources between school districts; it is commonly distributed according to foundation type formulas.[2] The essential features of these formulas are that they (1) seek to provide at least a minimum or foundation level of education on a per pupil, per teacher, or per classroom unit basis, regardless of the pupil's location or the wealth of his district; (2) require a local contribution toward the financing of the foundation level of education, typically defined as an equal minimum property tax levy in each district, and (3) allow the residents an opportunity to tax themselves if they wish to finance additional educational expenditures.

Some consideration is given to local ability to provide public education by the deduction of the proceeds of a minimum property tax levy from the amount of aid that is designed to bring expenditures in each district to at least the foundation level. Foundation formulas sometimes carry this economic adjustment a step farther by including some consideration for the income of district residents or retail sales. The formulas also sometimes adjust for cost differences. These allowances have typically not been carried to full equalization on the basis of educational needs. The courts' unwillingness to consider this matter accounts for the focus on neutrality rather than on compensatory programs.[3]

In addition to the foundation assistance, states often provide a system of categorical grants. Such grants are sometimes employed as alternatives to a foundation program that includes additional factors designed to adjust for cost and associated need differentials between school districts. A third type of common grant is given at a flat, or fixed per pupil rate. As found in *Serrano v. Priest*, this type of grant has contributed much to the lack of equalization of state aid.

The residents of relatively rich districts may wish to tax themselves and provide a high quality of education; states often permit school districts to do so with no interference. Under some proposals for reform this freedom of action would be restrained. The Advisory Commission on Intergovernmental Relations would limit locally financed expenditures to ten per cent of total expenditures.[4]

District power equalization, as proposed by Coons, Clune, and Sugarman would require that, beyond some minimum level which may be prescribed by the state, each district be permitted to spend whatever it chooses but that these expenditures would not depend on the wealth of the district. Their plan requires that the aid formula give crucial weight to the relative wealth of each district in that relative abilities would determine the state's contribution. Percentage equalization that is similar to district power equalization was proposed some time ago by Benson and more recently by Brazer.[5] Local control of the level of expenditures would be retained under this program, but the direct connection between district expenditures and district wealth would be broken. The local determination of the level of educational expenditures has the advantage of being efficient in that spending would be determined by local rather than statewide preferences that would be involved with the state assuming the responsibility of public education; Brazer makes much of

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this point. Relatively poor districts would find that they could spend more than they raise locally, and relatively rich districts would find that their state aid would be negative. Both district power equalization and percentage equalization would continue local property taxes; all that would change would be the state supplement to locally raised revenues.

Federal Assistance

The federal government has assumed only a very limited role in the support of elementary and secondary education. Federal aid is provided through a system of categorical grants that are largely need-oriented; poor districts are aided as a consequence of aid to poor people. While this aid contributes to a reduction of interstate differences, the aid is neither large enough nor distributed with enough variation among the states to equalize fully the ability to provide public education.

IMPLICATIONS OF THE COURT DECISIONS

It is a little early to be certain about the details of the system of educational finance that might develop to satisfy the requirement of fiscal neutrality but some general characteristics can be projected with a fairly high degree of certainty.

One element of the new system will undoubtedly be a changed role for the property tax. It is clear that the court decisions will require that the locally determined property tax no longer be relied on to provide the majority of the support of a school district's expenditures.

Five general types of revenue systems may develop as products of alternative approaches to fiscal reform. These approaches range from minimal modifications of the present system designed to be just sufficient to satisfy the courts, to a full-fledged restructuring of educational finance in the spirit of fiscal neutrality.

In the first type local finance would be retained essentially intact. The modification consists of substitution would maintain a local responsibility for financing a sizeable portion of the educational expenditures and would retain existing state aid formulas. For this type of modification to satisfy the courts, it must be that the interdistrict distribution of local sales tax and/or income tax revenues is sufficiently equal to provide a satisfactory source of educational finance.

A second possibility is a system that retains the present role for the local property tax but modifies the distribution of state aid. There need be no change in the total amount of state aid or in the revenue source of these funds. So long as the aid is of sufficient magnitude, some distribution of this aid among the school districts would produce the required fiscal neutrality. In most states such a modification would involve major revisions of state aid formulas.

By relying on the local property tax to continue to make its typically large contribution to financing education but changing the distribution of the proceeds of this tax among the school districts, a third type of financial system may develop. School consolidation could produce such a system. It is this type of change that would be required if district power equalizing or the percentage equalizing systems of finance were adopted. These systems involve some of the characteristics of a statewide property tax and an alteration in the distribution of state aid. As a result the state would create a financial environment in which the local school district retains the responsibility for initiating the particular distribution of state aid that comes to exist and the resulting level of educational services that would be provided.

The remaining two possible revenue systems involve a reduction in the local property tax, an increase in the amount of state aid, and a distribution of this aid so as to secure fiscal neutrality. The state would assume the role of determining the exact distribution of aid; the local role would be much more passive than under the third type of financial system. If state aid were made a very large portion of total expenditures, the Advisory Commission on Intergovernmental Relations proposed system of relatively full state financing would be created. The state could formally substitute a state property tax for the local property tax levied for educational purposes; this arrangement would be the fourth possible type of revenue system. Finally, the fifth system differs from the fourth only in the source of state funds. The fifth modifies the present system of educational finance by substituting state sales or income tax funds for local property tax revenues.

It should be clear that a continuation of a property tax is perfectly consistent with the principle of fiscal neutrality. What must change

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is the direct link between locally raised revenues and public school expenditures to the extent that this link produces unequal abilities to provide for public education.

ECONOMIC CONSEQUENCE

The economic consequences that may be anticipated to result from the change to a fiscally neutral system of educational finance can be divided into two broad groups: (1) the effects on the distribution of income, and (2) the effects on resource use.

Income Distribution

An alternative program of education finance will undoubtedly affect the relative prices of economic resources and consequently the relative prices of goods and services produced with these resources. Thus, an individual or group will experience a change in their relative well-being on the sources side through a change in the prices he obtains from the sale of his services and on the uses side through the price he pays for the products he buys.

To the extent that the move to fiscal neutrality increases funds available to school districts, some increase in expenditures on inputs to the educational process would result. Teachers and other suppliers of educational services would experience an increase in the demand for their products. In the short run, the supply of these goods and services is quite inelastic. While an individual school district may be able to attract better trained or more experienced teachers by offering higher salaries, all districts seeking similar improvements in the teacher input will be unable to affect a significant improvement in teacher quality. All that would happen in the short run would be an increase in the relative income of teachers. In the longer run, the higher salaries may attract a different type of person into the profession and may generally improve teacher quality. In the longer run, as the quantity of educational resources respond to the higher prices, the income advantage resulting from short-run rigidities will be reduced. In the market for many educational resources, the adjustment time period may be quite short. In others, such as the market for teachers, the adjustment process may be long and the income advantage may persist for quite some time, particularly when consideration is given to what amounts to a restrictive licensing procedure.

The doctrine of tax capitalization states that when certain conditions are met, changes in taxes levied on assets in fixed supply will be directly and fully reflected in the market value of the taxed assets. The real property tax meets these conditions. Thus, it is generally held that the immediate effect of the property tax is to reduce the value of all taxed real property. As adjustments occur in the long run, the tax on the unimproved value of land comes to be reflected in the value of land. Because the tax on improvements is shifted to the occupier, no long-run effect on the value of improvements results

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from the property tax. Consequently, the full burden of the land tax is suffered by the owner of the land when the tax is first imposed or first anticipated. One of the conditions that is required for tax capitalization is that a tax differential is present; property taxes levied at a uniform rate on all property would not be capitalized. The presence of different effective rates and the limited applicability of the tax in all states create an environment in which tax capitalization may be expected.

Just as some tax differentials will reduce the value of taxed property, some differential expenditure benefits will enhance property values. Each of the possible alternatives to the present system of educational finance involves a reduction either in the degree of reliance on the property tax or in differential property tax rates among some school districts or both. In either situation there would be a reduction of the tax and educational service differential in some districts and hence the amount to be capitalized. One of the geographic areas in which the value of land will rise is the central city, where school taxes are now high and educational spending is low. Rich suburban areas, with relatively low taxes and high quality education, will experience a decline in property values, particularly land values in the long run and both land and improvement values in the short run.

A reduction in the relative importance of the property tax through the substitution of sales and/or income taxes would affect the distribution of income by changing the distribution of tax payments. For example, those groups who own large amounts of property and earn little income would profit, while high income, low property ownership groups would be made worse off—lawyers would lose and farmers would gain. In the aggregate fairly certain statements can be made about the distribution of the tax burden by income class. Of the three taxes (sales, income, and property), the property tax is the most regressive; Dick Netzer says, "the most regressive of the major forms of taxation used in the United States." Some net reduction in regressivity would occur if a sales tax were substituted for the property tax, particularly if food purchases are exempt (or a credit is given) and services are taxed; the change in the overall degree of regressivity would be slight at most. A much more significant change, even possibly to progressivity, would result from a switch to an income tax.

A modification of the revenue system may also alter the distribution of income between school districts. Changes in state aid would produce an effect from the tax side; this effect would depend on the school district incidence of the taxes employed to finance the aid. Tax exporting and the property tax on nonresidential property complicate the argument but, as with individuals or groups, whether a particular district benefits or suffers as a result of the move to fiscal neutraliity depends on the net distribution of state taxes and state aid.

Consumers will be made better or worse off to the extent that the prices of the products they buy change. Individuals whose preferences are weighted toward goods produced with relatively large amounts of resources that increase in price would lose and conversely, individuals who do not highly value such goods would gain.

Resource Use

Modifications in the system of educational finance could have very substantial effects on the use of productive economic resources. These effects could involve both changes in the quantities of resources employed in production and changes in the efficiency of the use of these factors of production.

The input mix of resources is influenced by relative prices of the factors of production. Consequently, changes in the input mix can result from tax modifications as they influence resource prices. To the extent that property taxes are reduced, producers will be encouraged to substitute real property for other factors of production; methods of production involving relatively large amounts of capital will be encouraged; intra-industry variations will also depend on relative capital inputs. The elimination of the tax wedge that has been driven between the productivity of capital and its price would end an economic distortion, and as a result economic resources would be employed in a more nearly optimum fashion.

These price effects will influence not only the input mix of resources but also the output mix of products. This output change is the consequence of differences in the portion of the total cost represented by the factor of production experiencing a price change. If little capital is used in the production of a particular good, the reduction of the property tax will not significantly affect the price of the good; the opposite holds for goods involving large capital inputs.

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Thus, the price of automobiles should decline in relation to the price of haircuts.

One of the most substantial consequences of a reduction in the property tax should show up in the housing sector of the economy. The improvements part of the present tax on residential property is borne by the occupier. This tax is thus the equivalent of an excise tax; property tax rates translate this tax to an 18 to 30 per cent excise levied in housing expenditures.[6] Compared to the more typical four per cent rate of general sales taxes, property taxes are at rates typically reserved for the sumptuary fields of cigarette and liquor taxation. A reduction of the property tax could be expected to encourage a considerable replacement of the nation's older housing and an improvement in the maintenance of existing houses.

One of the major consequences of a move to fiscal neutrality would be on the quality of public education. In at least some jurisdictions (those presently disadvantaged because of low per pupil wealth), educational expenditure increases and educational quality improvements would confer an advantage to the pupils who are the obvious primary beneficiaries of education. An improvement in education should increase the nation's long-term rate of economic growth, as the conclusions of the extensive studies of the contribution of investment in human capital to growth would support. But, at a more individual and perhaps subjective level, there may finally be an end of an educational system that contributes to the personal tragedy for those who obtain an education qualifying them for no more than the welfare rolls or the prisons.

The geographic location of economic activity can also be influenced by changes in the system of educational finance. This could come about in two ways. There could be an (1) alteration in public policy having locational consequences or (2) alteration in autonomous market forces exerting economic pressures for locational adaptions. Extensive studies of the determinants of the location of economic activity have concluded that taxes and public expenditures can exert a marginal influence on location; while this influence may be modest between states, fiscal variations can be powerful determinants of location within a metropolitan area. This is because other larger costs, such as wage rates, differ much more between states than between alternative locations in a metropolitan area. As property tax and education quality differentials are reduced, their weight in locational decisions will decline. This would mean that high tax and low education spending areas such as central cities and, to a lesser extent, rural areas should become more attractive locations while suburban areas should become less attractive; hence, the "flight to the suburbs" on the part of the rich should be reduced.

Fiscal neutrality in which the financial system equalizes ability would reduce the advant-

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age to be gained by attracting business and industry to an area; similarly the disadvantage associated with having relatively low income families with large numbers of children move into the community would be reduced. These changes may help reduce present restrictive zoning, and similar techniques of fiscal mercantilism as well as excessive reliance on financial criteria in land use planning such as large lot minimums or limits on the number of bedrooms a house can contain. Industrial enclaves may disappear and industry may be more sensibly located in the urban area—manufacturing and wholesaling would be drawn back into the central city. The reluctance to adopt metro-wide solutions to urban problems would be reduced through the reduction in the local desire to keep any particular tax advantage.

While intrastate competition for economic activity might be reduced, interstate competition would be undiminished; state development agencies would probably expand relative to local development groups; while local subsidies to location may be reduced, state subsidies would likely remain. On the negative side, a reduction in land taxation may reduce the cost of land speculation (by reducing the cost of withholding land from use) and may reduce the land component of urban property; this would contribute to urban sprawl and disjointed leapfrogging at the urban fringe. Other locational influences of fiscal neutrality also would be negative. Whenever prices do not reflect costs an economic distortion is likely. A public subsidy would be given if the tax-price of a particular location did not reflect the full public costs at the site. Fiscal neutrality may appear advantageous on equity grounds, but it does involve some distortion resulting from the subsidy to location in high cost areas. This distortion would tend to make cities larger than they otherwise would be and rural areas unduly depopulated.

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[1]Serrano v Priest, 5 Cal. 3d 584, 487 P. 2d 1241, 96 Cal. Rpt. 601 (1971); Van Dusartz v. Hatfield, F. Supp. (D. Minn. 1971); Rodriquez v. San Antonio Independent School District, F. Supp. (W. D. Texas, 1971); and Robinson v. Cahill (Superior Court of New Jersey, January 1972). These cases are the foundation of the current round of cases dealing with educational finance.

[2]George D. Strayer and Robert M. Haig, The Financing of Education in the State of New York, Report of the Educational Finance Inquiry Commission (New York: Macmillan, 1923); Paul R. Mort, W. C. Reusser, and J. W. Polley, Public School Finance, 3d ed. (New York: McGraw-Hill, 1960); and John E. Coons, William H. Clune III, and Stephen D. Sugarman, Private Wealth and Public Education (Cambridge, Massachusetts: The Belknap Press of Harvard University Press, 1970), chs. 2-4.

[3]McInnis v. Shapiro, 293 F. Supp. 237, 322 (N.D. Ill. 1968), aff'd per curiam sub nom. McInnis v. Ogilvie, 394 U.S. 332 (1969); and Burruss v. Wilkerson, 310 F. Supp. 572, 574 (W.D. Va. 1969), aff'd per curiam 397 U.S. 44 (1970).

[4]Advisory Commission on Intergovernmental Relations, 1970 Cumulative ACIR State Legislative Program (Washington D. C.: the Commission, 1969); a somewhat similar recommendation recently has been made by the New York State Commission on the Quality, Cost and Financing of Elementary and Secondary Education, the Fleischmann Commission.

[5]Charles S. Benson, The Cheerful Prospect: A Statement of the Future Public Education (Boston: Houghton-Mifflin, 1961) and Harvey E. Brazer, "The Case for Local Control and Financing of Elementary and Secondary Education," National Tax Association, Proceedings of the Sixty-fourth Conference on Taxation of the National Tax Association (Columbus, Ohio, 1972).

[6]Dick Netzer, Impact of the Property Tax (Washington, D. C.: National Commission on Urban Problems, 1968), pp. 13-15.